IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 865

THE ESMOND MILLS *et al.*,
Petitioners,

v.

GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT AND BRIEF IN SUPPORT THEREOF.

ANDREW B. TRUDGIAN,
Counsel for Petitioners.

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Petitioners respectfully pray that a writ of certiorari issue to review a judgment of the Circuit Court of Appeals for the First Circuit entered in the above cause on January 23, 1943.

Opinions Below.

The opinion of the Tax Court of the United States (R. 57-63) is not reported. The opinion of the United States Circuit Court of Appeals for the First Circuit (R. 73-80) is reported in 132 F. (2d) 753.

Jurisdiction.

The judgment of the United States Circuit Court of Appeals was entered January 23, 1943. The jurisdic-

tion of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

For the calendar year 1937, the respondent disallowed deductions on the return of the petitioner, The Esmond Mills, in the amount of $33,904.95 for shrinkage in inventory in the name of its wholly owned subsidiary, The Smithfield Company, and in the amount of $31,636.19 for payments made by it to The Smithfield Company which were in turn paid by The Smithfield Company to cancel outstanding unfavorable purchase contracts, on the ground that they were not losses sustained or ordinary and necessary expenses paid in the conduct of the business of petitioner. The Smithfield Company held its inventories and entered into its purchase contracts for the sole benefit of The Esmond Mills, its parent corporation, there being an arrangement between the two corporations whereby The Smithfield Company transferred inventories carried in its name to The Esmond Mills at cost plus commissions (R. 41). The Smithfield Company was a mere shell, financially speaking, and unable to make any payments to cancel contracts without the aid of The Esmond Mills. The Circuit Court of Appeals has sustained the respondent's determination of the disallowance of these two deductions on the theory that there was no agency and that a taxpayer cannot ignore the separate entity of a corporation owned by it, even though it is a mere shell. The questions presented are:

I—Whether a taxpayer can ignore the separate entity of a subsidiary corporation which is a mere shell and deduct the subsidiary's losses on its own return.

II—Whether a taxpayer, having elected to conduct a portion of its business through a subsidiary corporation having no substance of its own, is estopped from denying its separate entity even where its subsidiary is a mere shell.

III—Whether there was a relationship of agency between The Esmond Mills and The Smithfield Company, so that the inventory losses of the latter are deductible by the former.

IV—Whether a payment made by a parent to a subsidiary which is immediately turned over to a third person for the purpose of cancelling outstanding unfavorable contractual obligations incurred for the parent's benefit and where the subsidiary is financially unable to make such payment is not an ordinary and necessary business expense of the parent corporation.

Statement.

The facts as found by the Tax Court of the United States (R. 58-61) and as contained in the Stipulation of Facts (R. 39-42) are as follows:

The petitioner, The Esmond Mills, hereinafter called Esmond, was a Massachusetts corporation whose principal place of business was located at Esmond, Rhode Island (R. 59). During the calendar year 1937, it was engaged in the manufacture and sale of blankets and other products (R. 59). The Smithfield Corporation, hereinafter called Smithfield, is a Massachusetts corporation whose principal place of business is also located at Esmond, Rhode Island (R. 59) and whose stock was wholly owned by Esmond (R. 59). During the calendar year 1937, Smithfield was en-

gaged solely in the business of buying cotton and wool, title remaining in its name until transferred to Esmond (R. 60), and it did not pay salaries to officers nor wages or salaries to any employees and did not pay rent (R. 51). Esmond bought a large part of the cotton and wool consumed by it through Smithfield (R. 60). On the transfer of title to Esmond, Smithfield was credited with the cost of the cotton and wool transferred, plus "commissions". This was the only class of income realized by Smithfield during 1937 (R. 60) and reported on its tax return (R. 50). Both companies kept their books on an accrual basis (R. 48, 55) and Esmond valued its inventories at the lower of cost or market (R. 48).

During 1937, Smithfield purchased a quantity of cotton and wool and thereafter the market declined, so that as of December 31, 1937, the market price of such cotton and wool then on hand was $33,904.95 less than cost (R. 60). Thereupon, Smithfield reduced the book value of the inventory in its name on December 31, 1937 by the amount of $33,904.95, but did not reflect such reduction in its income and excess profits tax return for 1937 (R. 60) since it did not derive income from the purchase and sale of merchandise, but only from commissions earned (R. 51). Esmond, however, paid this amount to Smithfield (R. 60) and deducted it on its return (R. 46).

During 1937, there was a general decline in the market prices of cotton and wool. During that year, Smithfield had outstanding contracts to purchase cotton and wool, which because of the decline in the market prices, were entered into at higher prices than those then prevailing. Smithfield obtained the cancellation of these unfavorable purchase contracts during 1937 by the payment of $31,636.19 to certain

brokers which was advanced by Esmond to Smithfield without reimbursement (R. 60, 61). On its income and excess profits tax return for 1937, Esmond claimed this as a deduction.

On June 30, 1940, the petitioner, The Esmond Mills, Inc., a Rhode Island corporation, took over all the assets of Esmond and assumed all its liabilities. It admits that it is the transferee of Esmond and liable for the payment of any deficiencies which may be found to be due from Esmond for 1937.

By letter dated December 20, 1940 addressed to Esmond (R. 11) and by letter dated April 30, 1941 addressed to The Esmond Mills, Inc. (R. 27), the respondent disallowed the deductions of $33,904.95 and $31,636.19 taken by Esmond. The petitioners thereupon appealed to the Tax Court of the United States (R. 6, 22) which sustained the respondent's disallowance (R. 63, 64). On appeal to the Circuit Court of Appeals, First Circuit, this order was affirmed (R. 79).

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1—In holding that the evidence does not establish a relationship of agency between Esmond and Smithfield.

2—In holding that Smithfield is a separate corporate entity for tax purposes.

3—In failing to hold that Smithfield's limited activities solely in behalf of Esmond did not result in an agency relationship between the two corporations.

4—In failing to hold that Smithfield's separate entity should be ignored because of its lack of substance.

5—In failing to hold that the payment by Esmond to Smithfield of the sum of $31,636.19 to be used for the purpose of cancelling its unfavorable purchase contracts which ultimately would have devolved on Esmond was not an ordinary and necessary business expense, or a full deductible loss.

6—In affirming the decision of the Tax Court of the United States.

Reasons for Granting the Writ.

The decision of the Circuit Court of Appeals, First Circuit, in the instant case is in direct conflict with the principles enunciated by this Court in the cases of *United States* v. *Lehigh Valley Railroad Co.,* 220 U. S. 257; *Southern Pacific Railroad Co.* v. *Lowe,* 247 U. S. 330, and *Gulf Oil Co.* v. *Lewellyn,* 248 U. S. 71, to the effect that the corporate entity of a subsidiary corporation will be ignored where it is a mere department, branch or instrumentality of its parent. It is also in direct conflict with the decision of the Circuit Court of Appeals, Fourth Circuit, in the case of *U. S.* v. *Brager Building and Land Corp.,* 124 F. (2d) 349, with the decision of the Circuit Court of Appeals, Third Circuit, in the case of *North Jersey Title Insurance Co.* v. *Comm.,* 84 F. (2d) 898, and with the decision of the Circuit Court of Appeals, Tenth Circuit, in the case of *Inland Development Co.* v. *Comm.,* 120 Fed. (2d) 986. The decision of the Circuit Court of Appeals, First Circuit, in the instant case is likewise in conflict with the decision of the Circuit Court

of Appeals, Second Circuit, in the case of *Helvering v. Community Bond & Mortgage Corp.*, 74 F. (2d) 727, and with the decision of the Circuit Court of Appeals, Ninth Circuit, in the case of *Seufert Bros. Co. v. Lucas*, 44 F. (2d) 528, both of which cases enunciate the principle that expenditures made to minimize losses are deductible from net income either as ordinary and necessary expenses or as losses.

On March 8, 1943, this Court granted writs of certiorari to review the decisions of the Circuit Court of Appeals, Fifth Circuit, in the case of *Comm. v. Moline Properties, Inc.*, 131 F. (2d) 388, Docket No. 660, and of the Circuit Court of Appeals, Eighth Circuit, in the case of *Interstate Transit Lines v. Comm.*, 130 F. (2d) 136, Docket No. 552. The issue in both these cases is identical with that of the instant case, whether a taxpayer can deny for tax purposes the separate entity of a subsidiary which is a mere instrumentality with no substance, and this Court having granted a review in those cases, should grant it in the present case. Further, the Circuit Court of Appeals, First Circuit, in its decision which this petition seeks to review, relied on the decision of the *Interstate Transit Lines* case, *supra*, as a binding precedent and, therefore, its *ratio decidendi* is no longer valid in view of this Court's consent to review that case.

Conclusion.

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

ANDREW B. TRUDGIAN,
Counsel for Petitioners.

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI.

POINT I.

A taxpayer can ignore the separate entity of its subsidiary corporation where it is a mere instrumentality with no substance of its own.

Smithfield, the subsidiary corporation in the instant case, is a mere instrumentality or department of its parent, Esmond. Its tax return for 1937 (R. 50) which is part of the stipulation of facts, shows that it did not pay salaries to officers nor salaries or wages to employees, and did not pay rent. Its only expenses were taxes, accounting fees and miscellaneous items. Its only source of income was commissions made on the transfer of goods to its parent, Esmond, at cost. Its inventories were not used in determining income since it made no income from the purchase and sale of merchandise. Its balance sheets at the beginning and end of the year show that it was financially unsound and unable to make the payment of $31,636.19 without Esmond's help. It was a mere hollow shell, without substance, and completely dependent on and under the domination and control of Esmond.

Since the decision of this Court in the case of *United States* v. *Lehigh Valley Railroad Co.*, 220 U. S. 257, there has been a well established rule that the separate corporate entity of a subsidiary corporation will be ignored where it is a mere instrumentality of

the parent corporation. This case was cited favorably in *United States* v. *Reading Co.,* 253 U. S. 26, and the *ratio decidendi* further explained as follows (p. 62): "yet where such ownership of stock is resorted to not for the purpose of participating in the affairs of the corporation in which it is held in a manner normal and usual with stockholders, but for the purpose of making it a mere agent or instrumentality or department of another company, the courts will look through the forms to the realities of the relation between the companies as if the corporate agency did not exist and will deal with them as the justice of the case may require." And this rule of law has been carried over into tax cases, *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435; *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71. In the *Southern Pacific* case the court held that dividends which otherwise would be taxable are exempt from taxes since they were received from a subsidiary corporation which was merely a part of its parent, "acting merely as its agent, and subject in all things to its proper direction and control".

While this rule of law is a well established one and has never been questioned, it is only an exception to the general rule that a corporation's separate entity will not be ignored, and is limited to cases where fraud or injustice would otherwise result or where a corporation is used as a mere department or instrumentality of another.

However, since the decision of this Court in the case of *Higgins* v. *Smith,* 308 U. S. 473, decided January 8, 1940, the Government has contended that the precedent established in the *Southern Pacific Co.* case, *supra,* and similar cases has been overruled and re-

placed by a broad rule that in tax cases the Government has the option of relying on or ignoring the separate entity of a wholly-owned corporation. This contention was made in the case of *U. S.* v. *Brager Building & Land Corp.*, 124 F. (2d) 349 (Circuit Court of Appeals, Fourth Circuit), in the following language quoted by the court from the Government's brief: "The general rule appears to be that the corporate entity may be disregarded by the government in furtherance of the collection of proper taxes, but may not be disregarded by its creator to reduce tax liability." The court, however, rejected this contention, saying: "But it is going too far to say that if a taxpayer forms a corporation for his convenience, he is thereafter estopped from disclosing the true nature of the arrangement whenever it is of advantage to the government to recognize only the corporate form. The advantage of the taxpayer has been served by many decisions in which the identity of the corporation and its sole stockholder has been adjudicated, and we do not understand that this body of the law has now for practical purposes ceased to exist." To the same effect are the cases of *North Jersey Title Insurance Co.* v. *Comm.*, 84 F. (2d) 898 (3rd Circuit) and *Inland Development Co.* v. *Comm.*, 120 F. (2d) 986 (10th Circuit).

These decisions are in conflict with the decisions of the Fifth and Eighth Circuit Courts of Appeals in the cases of *Comm.* v. *Moline Properties, Inc.*, 131 F. (2d) 388 and *Interstate Transit Lines* v. *Comm.*, 130 F. (2d) 136, respectively, but these two cases have been brought up for review by this Court by writs of certiorari granted March 8, 1943, their docket numbers being 660 and 552 respectively.

In view of the fact that the issue in the instant case on the recognition of the separate corporate entity of a wholly-owned corporation is identical with the ones in these cases brought up for review, and since the Circuit Court of Appeals in the instant case based its decision on the rule of the *Interstate Transit Lines* case, it is submitted that this case should be brought up for review by this Court together with these two cases already before the court.

POINT II.

The advances made by Esmond to Smithfield to reinstate its inventory depreciation and to cancel its unfavorable purchase contracts were deductible either as ordinary and necessary business expenses or as losses.

Under the practice established between Esmond and Smithfield (R. 41), when stocks of cotton and wool were transferred to Esmond, Smithfield was credited with the cost thereof plus commissions. Therefore, all inventory losses were absorbed by Esmond, and its losses were not the indirect ones sustained by any corporate stockholder when his corporation incurs a loss, but a direct merchandising one arising from its course of dealings with Smithfield.

But even if the lower court were correct in holding the loss on inventory depreciation to be non-deductible, it was patently wrong in holding the payment of $31,636.19 for the cancellation of Smithfield's unfavorable purchase contracts to be non-deductible. The course of dealings between the two corporations effected the loss caused by declining markets to fall on Esmond, and it had the right to minimize these

losses, and to deduct the amounts expended therefor, irrespective of the corporate relationship between Smithfield and Esmond.

A case in point is *Helvering* v. *Community Bond & Mortgage Corp.*, 74 F. (2d) 727 (Circuit Court of Appeals, Second Circuit). In that case, a real estate corporation had employed another to be its exclusive selling agent for the sale of its stock. Discovering that this agent was acting in such a way as to impair its business reputation, it purchased the capital stock of this corporation and thereupon cancelled the exclusive selling agency, and deducted the purchase price of this stock as a loss on its tax return for that year. The Circuit Court of Appeals sustained this deduction, saying: "It is not an unusual occurrence of business for a business enterprise, burdened with an unprofitable contract, to secure its cancellation by payment of money, and it is difficult to see why an expense thus incurred is not an 'ordinary and necessary expense according to the ways of conduct and the forms of speech prevailing in the business world'. *Welch* v. *Helvering*, 290 U. S. 111, 54 S. Ct. 8, 9, 78 L. Ed. 212." Similarly, in the instant case, Esmond, because of the declining markets prevailing in 1937 (R. 41), and its commitment to take over Smithfield's inventories at cost, was faced with merchandising losses which were steadily increasing. It therefore had the right to minimize these and the sums expended in so doing were properly deductible under the doctrine of the above cited case. The case of *Seufert Bros. Co.* v. *Lucas*, 44 F. (2d) 528 (Circuit Court of Appeals, Ninth Circuit), is similar to the *Community Bond & Mortgage Corp.* case, *supra*. There, a payment made to alter the location of a new

highway so as not to damage the taxpayer's property (which the highway as originally planned would have done) was held to be a deductible loss, and the principle enunciated that payments made to avoid larger losses were deductible as losses. This decision also is in conflict with the decision of the lower court in the instant case.

CONCLUSION.

In view of the conflict of the decision of the Court below with various decisions of this Court and the other Circuits, and because this Court has already agreed to review the questions of the estoppel of a taxpayer to deny the existence of its own "dummy" corporation and of the Government's right to rely on or ignore the existence of a corporate entity, this petition for a writ of certiorari should be granted.

Respectfully submitted,

Andrew B. Trudgian,
Counsel for Petitioners.

APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648.

Sec. 22—Gross Income.

(a) General Definition.—"Gross income" includes gains, profits and income derived from * * * businesses, commerce, * * *.

(c) Inventories.—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 23.—Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

(f) Losses by Corporations.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

Sec. 41.—General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the

method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

Sec. 43.—Period for which Deductions and Credits Taken.

The deductions and credits * * * provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

TREASURY REGULATIONS 94 (1936 Ed.).

Art. 22 (a) (5). Gross Income from Business.—In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold * * *.

Art. 22 (c) (1). Need of Inventories.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise

purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected.

Art. 22 (c) (2). Valuation of Inventories.—Section 22 (c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

*   *   *   *   *   *   *   *

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22 (c) are (a) cost and (b) cost or market, whichever is lower. * * *

Art. 22 (c) (4). Inventories at Cost or Market, whichever is Lower.—Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(a) Of goods purchased and on hand, and

(b) Of basic elements of cost * * *.

Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

Art. 23 (a) (1). Business Expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected

with or pertaining to the taxpayer's trade or business * * *. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income * * *. Among the items included in business expenses are * * * commissions * * *.

Art. 23 (f) (1). Losses by Corporations.—Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible except in so far as not prohibited or limited * * *.

Art. 41 (1). Computation of Net Income.—* * * The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income.

Art. 41 (2). Basis of Computation and Changes in Accounting Methods.—The true income, computed under the Act and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. * * *

Art. 41 (3). Methods of Accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. * * *

In the Supreme Court of the United States

October Term, 1942

No. 865

The Esmond Mills et al., petitioners

v.

Guy T. Helvering, Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT

Although we believe the decision below to be correct, we do not oppose the granting of a writ of certiorari in this case.

The question presented is whether amounts paid by the petitioner, The Esmond Mills, to its subsidiary, The Smithfield Company, (1) to reimburse the subsidiary for losses incurred because of a decline in its inventory values, and (2) to enable the subsidiary to obtain cancellation of certain purchase contracts, were deductible in determining the net income of the petitioner for the calendar year 1937. Fundamentally the issue is whether a parent corporation is entitled, for in-

come-tax purposes, to disregard the separate corporate identity of its wholly owned subsidiary and to deduct losses of the subsidiary as its own losses or ordinary and necessary business expenses.

This Court has granted petitions for writs of certiorari in *Moline Properties, Inc.* v. *Helvering*, No. 660, and in *Interstate Transit Lines* v. *Helvering*, No. 552, which involve similar questions with respect to taxation of the income of separate entities operated under common ownership. We believe that there are substantial differences between the instant case and those in which certiorari has been granted. However, we do not oppose the granting of this petition, since the Court now has before it for decision the question of whether the corporate identity of wholly owned subsidiaries may be disregarded for income-tax purposes; but we suggest that the Court may wish to withhold action upon this petition until those cases are decided, so that this case may be disposed of in the light of the decisions therein.

Respectfully submitted.

Charles Fahy,
Solicitor General.

April 1943.

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